STATEMENT OF DR. MARK N. COOPER
ON BEHALF OF THE
CONSUMER FEDERATION OF AMERICA AND CONSUMERS UNION

THE ENERGY POLICY ACT OF 2005

SUBCOMMITTEE ON ENERGY AND AIR QUALITY
U.S. HOUSE OF REPRESENTATIVES

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Mr. Chairman and Members of the Committee,

My name is Dr. Mark Cooper. I am Director of Research for the Consumer Federation of America. I appreciate the opportunity to share the views of CFA and Consumers Union on energy policy. Over the past half-decade we have analyzed each of the major components of the consumer energy bill – gasoline, electricity and natural gas. I have attached copies of four major analyses.

A COMPREHENSIVE APPROACH TO POLICY EVALUATION

Our approach reflects a comprehensive evaluation of energy policies on both the supply and demand sides of the market and takes into account three broad areas of policy concern – economics, environment and security.

For the consumer, the primary considerations are economic, but environmental and security considerations must be taken into account. Economics includes both the basic benefit/cost of each option and the impact of the option on the market structure. We prefer policies that meet the need for energy at the lowest cost. We prefer policies that increase the supply and demand elasticities in the market or bring new sources and actors to the market to promote competition, since this not only lowers price but also dampens price volatility. While minimizing costs is a goal, it is paramount that policy choices produce outcomes that are economically acceptable. In choosing between economically acceptable outcomes, policies that lower environmental costs and/or security concerns should be preferred.

Environmental concerns are extremely important because energy production and consumption involve major externalities – costs that are not easily reflected in market transactions. Production, transportation and distribution have environmental impacts, as does consumption. An alternative that saves on this infrastructure should be preferred.

Security of supply has traditionally focused on the operation of facilities to prevent accidents. Operating pipelines or transmission systems, terminals, drilling rigs and distribution systems are complex and difficult activities. They are subject to accidents and disruptions from weather and other problems. Under current conditions, however, vulnerability to intentional acts of sabotage must be considered. Moreover, because international energy markets are dominated by cartels and producers with market power, any policy that relies on foreign resources must also be assessed in terms of the dependability of supply.

CRITICAL STEPS FOR AN EFFECTIVE POLICY

We conclude that there are two critical first steps to establishing a balanced energy policy.

First, markets must be free of manipulation. We believe that strong measures to ensure confidence in markets are critical to establish the credibility of arguments for other policies. Ensuring market transparency and promoting greater storage could lower prices and reduce volatility, but, above all, they would establish a prerequisite necessary for other policies – confidence that there is a "hard" problem in the imbalance of supply and demand.

Second, improvement in energy efficiency must be the central pillar of our energy policy. The domestic resource base is mature and declining. Increases in production cannot significantly reduce our dependence on imports or affect world markets. Only by dramatically increasing the fuel efficiency or our vehicle fleet, buildings, equipment and appliances, can we significantly affect the supply-demand balance and alleviate pressures on markets. Efficiency has a positive impact on every one of the evaluation criteria. Its potential to lower prices has been noted. Efficiency has obvious environmental benefits by reducing the need for facilities and the consumption of fossil fuels. To the extent that it reduces the need for resources, it improves security. It could have market structural benefits, if demand is reduced sufficiently to shift the market equilibrium to a more elastic region of the supply curve.

PETROLEUM PRODUCTS

If the U.S. is to both reduce the market power of energy producers and stem the flow of imports, public policy must start immediately and aggressively on an efficiency path to lower energy consumption. It is time for public policy to seek permanent institutional changes that both reduce the chances that markets will be tight and reduce the exposure of consumers to the opportunistic exploitation of markets when they become tight. To achieve this reduction of risk, public policy should be focused on achieving four primary goals:

- Restore reserve margins by developing both efficiency (demand-side) and expanding refinery capacity (supply-side).
- Increase market flexibility through stock and storage policy.
- Discourage private actions that make markets tight and/or exploit market disruptions by countering the tendency to profiteer by withholding of supply.
- Promote a more competitive industry.

Demand Side

A goal of achieving an improvement of vehicle efficiency (increase in fleet average miles per gallon) equal to economy-wide productivity over the past decade (when the fleet failed to progress) would have a major impact on demand. It would require the fleet average to improve at the same rate it did in the 1980s. It would raise average fuel efficiency by five miles per gallon, or 20 percent. This is a mid-term target. This rate of improvement should be sustainable for several decades. This would reduce demand by 1.5 million barrels per day within a decade. This would return consumption to the level of the mid-1980s.

Expanding refinery capacity by 10 percent equals approximately 1.5 million barrels per day. This would require 15 refineries, if the average size equals the refineries currently in use. This is less than one-third the number shut down in the past ten years and less than one-quarter of the number shut down in the past fifteen years. Alternatively, a ten percent increase in the size of existing refineries, which is the rate at which they increased over the 1990s, would do the trick, as long as no additional refineries were shut down. Placed in the context of redevelopment of recently abandoned facilities or expansion of existing facilities, the task of adding refinery capacity does not appear daunting. Such an expansion of capacity has not been in the interest of the businesses making the capacity decisions. Therefore, public policies to identify sites, study why so many facilities have been shut down, and establish programs to expand capacity should be pursued.

Reducing demand for natural gas by about one quarter of the base level projection could be achieved with the implementations of three broad categories of policies – building codes, appliance standards, and industrial use – that essentially accelerate the adoption of currently available best practices or readily achievable savings with off-the-shelf technologies. The potential savings over a longer period are higher. The key challenge is to move higher efficiency products and practices into widespread use. Standards, incentives and education programs are the vehicles to do so. These discussions do not include the impact of a renewable portfolio standard, which could have a large effect on the electric utility sector. Although several states have recently adopted significant renewable standards, 10 to 20 percent, the federal government has not.

Stock Policy

It has become more and more evident that private decisions on the holding of stocks will maximize short-term private profits to the detriment of the public. Increasing concentration and inadequate competition allow stocks to be drawn down to levels that send markets into price spirals. Companies will not willingly hold excess capacity for the express purpose of preventing price increases. They will only do so if they fear that a lack of supply or an increase in brand price would cause them to lose business to competitors who have available stocks. Regional gasoline markets appear to lack sufficient competition to discipline anti-consumer private stock policies.

Public policy must expand stocks. Participants in the distribution of petroleum products could be required to hold stocks at a percentage of retail sales. Public policy could also either directly support or give incentives for private parties to keep storage. It could lower the cost of storage through tax incentives by drawing down stocks during seasonal peaks. Finally, public policy could directly underwrite stockpiles.

Market Manipulation

In the short term, government must turn the spotlight on business decisions that make markets tight or exploit them.

Withholding of supply should draw immediate and intense public scrutiny, backed up with investigations. Since the federal government is likely to be subject to political pressures not to take action, state governments should be authorized and supported in market monitoring efforts. An ongoing joint task force of federal and state attorneys general could be established. The task force should develop databases and information to analyze the structure, conduct and performance of gasoline markets.

As long as huge windfall profits can be made, private sector market participants will have a strong incentive to keep markets tight. Market manipulation could and should be made illegal. The pattern of repeated price spikes and volatility has now become an enduring problem. Because the elasticity of demand is so low – because gasoline is so important to economic and social life – this type of profiteering should be discouraged. A windfall profits tax that kicks in under specific circumstances will take the fun and profit out of market manipulation.

Further concentration of these industries is quite problematic. The Department of Justice *Merger Guidelines* should be rigorously enforced. Moreover, the efficiency defense of consolidation should be looked on skeptically, since inadequate capacity is a market problem.

ELECTRICITY

Policy makers could have eased the transition to competitive generation markets by recognizing the physical and institutional infrastructure that would be needed to support greater competition, but they did not. Perhaps they realized that presenting a true picture of the difficulty of electricity deregulation would have made it impossible to sell it to the public. Whatever the reason behind the underestimation of the difficulties of deregulation, the build-up of problems now makes the implementation of competition a much riskier proposition. Not only has the inadequacy of institutions and facilities grown, but also public confidence in the process has been eroded.

The nation is now deeply divided between about one-third of the states – primarily in the Midwest, Northeast and Mid-Atlantic – that have deregulated and restructured their electric utility sectors, and two-thirds that have not. Although there are a host of complex reasons behind this division, one cannot help but observe that, on average, those areas of the nation that remain fully regulated have substantially lower prices and more reliable service. Effective management of the grid does not require deregulation of either generation or transmission; on the contrary it is made more difficult by deregulation.

For the past decade, policy makers and regulators in Washington, D.C., and the Northeast have spent a lot of time trying to make the new electricity markets work. At the same time, they have neglected to upgrade and maintain a reliable electricity transport system. Congress and the FERC should devote all of their energy to studying, strengthening and managing the interstate transmission system – to promoting the public interest, not the profits of merchant generators and transmission owners.

Congress should pare back electricity legislation to a reliability-only title. Both the physical and institutional infrastructure of the industry needs careful study and consideration. It should not repeal the Public Utility Holding Company Act and require the FERC to abandon its Standard Market Design.

The Public Utility Holding Company Act (PUHCA) once was one of the main lines of defense against abuse of electricity and natural gas ratepayers. PUHCA was designed to simplify the ownership structure of electric utilities by ensuring a direct operational or functional relationship between subsidiaries of a holding company, and reduce conflicts of interest between the subsidiaries of vertically integrated multi-state utilities by examining accounting practices and reviewing affiliate transactions. Unfortunately, in recent years regulatory authorities have ceased to implement the law vigorously. Many consumer advocates believe that if the protections in PUHCA had been effectively enforced, the horrendous abuses in the Western power markets could have been avoided and *Standard and Poor's* recently concluded that PUHCA protects investors as well. Ironically, long after the Western electricity scandal broke, Enron's PUHCA exemption was revoked. Rather than repeal PUHCA, as contemplated in recent legislation, Congress should demand effective implementation of its provisions.

Congress should require a comprehensive survey of the national grid, since such a survey has not been conducted in forty years. It should identify the upgrades that are necessary for reliability and those whose primary purpose is to expand transactions. It should study the question of how best to establish standards and regulatory oversight over privately owned transmission lines. Voluntary self-regulation has been uneven and inadequate. Mandatory self-regulation is little better. More public oversight is necessary.

Congress should examine new institutions that can reconcile the interests of the states and include representation of consumer interests. FERC's proposal for regional, quasi-voluntary institutions of nebulous authority and ill-defined rights and responsibilities is not a solution.

Congress should require a framework for comprehensive planning that considers all alternatives. It should get serious about energy efficiency, like mandating higher minimum standards for air conditioners, which would reduce the demands on the grid at its most vulnerable times, hot summer days. It could also give a boost to local (distributed) generation, which has the double benefit of adding generation resources to the system while not using the long distance transmission lines, whose failure triggered the recent black out.